

The Fiasco of the American Laissez-Faire Financial Regulatory Regime: A Crisis-By-Crisis Critique of the Impact of Deregulation in American Financial Markets

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“And regulation entails organizational effectiveness, a chain of command, and a structure for logistical support.” [1]

— Sun Tzu
(Ancient Chinese Wartime Strategist)

Abstract: *In the west, regulation and deregulation are two highly contentious terms in policy discussions that often detract conservative free-market economists and their liberal counterparts from taking a role in bipartisan efforts towards better policy-making. Well, this paper focuses on the impact of deregulation and at times a ‘no-regulation-at-all’ government policy, before major financial setbacks in the past, with respect to the US economy. The recent repeal of DODD FRANK by the republicans in the HoR, which was set into motion by the Obama administration to regulate Wall Street banks who were mainly responsible for the global financial crisis of 07-08, is not a historic first in repealing the efforts to curb the financial menace caused by these ‘too-big-to-fail’ banks. I feel there is no better time going forward understanding and discussing regulatory frameworks concerning financial markets, in an age characterized by unprecedented progress in financial innovations. These markets are only going to get a lot more volatile, and at the same time expand extensively in terms of market capitalization. Moreover, without adequate checks and balances in place, it makes me wonder about the longevity of these innovations and the system that would harbor them. This paper critically evaluates, and thereby tries to understand, the impact and aftermath of deregulation in American financial markets, advocated by the proponents of the so-called laissez-faire financial regulatory regime.*

Keywords: *Deregulation, regulation...*

I. Introduction

The United States of America – the world’s largest economy since 1872 and the financial metropolis of the world for over a century. With a total market capitalization currently at a little over 135% of GDP, American financial markets are the largest in the world, home to around 132 corporations of the Fortune Global 500 list. The US is known for being the torchbearer for democracy, free-market capitalism and an abundance of entrepreneurial opportunity.

After the fall of the British Empire, the United States has been the economic, industrial and artillery powerhouse for much of the twentieth century and also very much into the twenty-first century, as China threatens to replace the US on the top.

In the last 100 years, ever since the culmination of world war -1, USA has been through some of the most severe financial crises of our times. Now that the world has become so economically interlinked, that the spill-overs have started affecting the rest of the world. The global financial crisis of 2007-08 is the greatest example we have.

The United States, because of the size of its massive economy and inherent risks within its own financial system, has also become a major global financial risk in the case of an economic meltdown or downturn. In the light of these events, this paper intends to focus on the impact of deregulation, and often the absence of regulation, crisis-by-crisis over the last 90 years in American financial history. Deregulation is good, but not all the time, as it has an inverse relationship with the health of an economy. Moreover, sometimes the privation of superintendence and no oversight have led to financial crises in USA.

A good regulatory regime is an adequate system of checks and balances in place, to ensure the effective functioning of the financial system by enhancing its ability to absorb shocks and maintain financial stability as well. The American laissez-faire financial regulatory regime functions contrary to this system.

Objectives:

- To analyze financial crises of the past 90 years within American financial markets and concomitantly assess the impact of deregulation.
- To evaluate ‘DODD-FRANK’.
- To discuss regulatory frameworks concerning modern financial innovations.

Methodology:

Data collected for the purpose of this paper are from secondary sources such as books, journals, government reports, reliable web sources and reputed media sources.

II. Crisis-by-Crisis Analysis – Regulatory Failures

Great Depression (1929-33):

The Great Depression is a great case study for a ‘hybrid failure’, which is the coalescence of market and regulatory failure.

- The Federal Reserve’s failure to raise interest rates, while the bubble was being blown as in between early 1920s to mid-1928, and thereby deflate the asset bubble that eventually burst in 1929.
- Incorrect policy response after the crash: The Federal Reserve raised interest rates after the crash in 1930, when they’d to lower them. [2]
- The banking sector of the US was all but small unit banks. These banks weren’t large or diversified enough to survive the crash, as if even one of their major debtors defaulted these banks would see rock-bottom. Depositors aware of this made bank-runs trying to remove all their money, which guaranteed that the banks fail. As the US economy grew a banking policy failure to merge these small unit banks to become large and diversified enough to absorb the shocks and contain the risks was one of the major reasons for the worsening of the crash. [3]
- Deferred stimulus and tardy regulatory reforms: Herbert Hoover, the 31st president of the US, took no consequential action to stop the ensuing financial apocalypse. Only after Roosevelt had sworn in in 1933, the Glass-Steagall Act of 1933 separating commercial and investment banking, and the Securities Act of 1933 to regulate the offer and sale of securities, were passed as measures to address the crash. [4]
- The creation of deposit insurance was late in the perspective of these bank-runs, as several banks had collapsed by then.

Savings & Loans Crisis (1980-89):

The high interest rate environment during the late 1970s resulted in huge losses from the S&Ls as depositors removed their money and deposited it in money market funds. The regulators induced upon the S&L crisis as they lacked sufficient resources to deal with the losses of the S&L industry; instead, they chose to deregulate the industry hoping that it would turn profitable.

- Policymakers passed the Financial Institutions Regulatory and Interest Rate Control Act 1978 & Depository Institutions Deregulation and Monetary Control Act of 1980 deregulating the whole industry, which gave them many of the capabilities of banks without the same regulations as banks and adequate federal oversight. [5]
- In 1982, Regan passed the Garn-St Germain Depository Institutions that enabled federally chartered S&Ls to diversify their activities. States followed in with similar reforms. [5]
- S&Ls began indulging in volatile & high-risk market situations overloading their balance sheets with considerable investments in high interest junk bonds and commercial realty only to find new sources of revenue. Depositors brought in deposits for want of higher rates and Federal Savings and Loan Insurance Corporation (FSLIC) insured them. In the late 80s, widespread corruption among other factors led to the insolvency of FSLIC, sparking a crisis.
- By 1995, more than 5000 S&Ls failed costing \$190Billion, most of it that the taxpayer had to bear. Regulatory chokeholds and policy missteps were the major reasons that created this crisis. [6]

LTCM Meltdown (1997):

The seventh chair of the Commodity Futures Trade Commission (CFTC), Brooksley Born, wanted her regulatory commission to have the power to oversee the OTC derivatives market as she foresaw the threats posed by an unregulated derivatives market. Nevertheless, the President’s Working Group on Financial Markets underpinned her efforts.

Halfway through the debate, LTCM, a major hedge fund, highly over-leveraged with a big portfolio of swaps collapsed with a record loss of \$1.6Billion in swaps alone. [7]

- In response, to regulate the OTC market, Congress passed the Commodity Futures Modernization Act of 2000. However, the final language of the bill exempted the CFTC and the SEC from regulating swaps and derivatives, which went on to be the major drivers of the global financial crisis of 2007-08. [7]
- The bill also had an exemption for energy derivative trading, also known as ‘Enron Loophole’. Which exempted over-the-counter energy trades from government regulation, thereby providing greater impetus for Enron to engage in trades outside federal regulation.
- In 2008, this loophole was closed as this loophole also had allowed speculators operating beyond federal oversight to drive up the cost of fuel. [8]

DOTCOM Bubble (2000):

US Congress passed two acts, one in 1997 that blew the bubble, and then in 2003 to end the disruption.

- The Taxpayer Relief Act of 1997(TRA97) lowered the maximum capital gains tax for individuals from 28% to 20%. However, dividends were taxed at previous rates, which made new low-or-no dividend companies preferable to dividend-paying companies. Moreover, these new companies were at center of the boom. [9]
- The Jobs and Growth Tax Relief Reconciliation Act of 2003 would set the tax rates for capital gains and for dividends equal to one another as they’d been before TRA97, ending the disruption. [10]

Global Financial Crisis (2007-08):

The Global Financial Crisis was a ‘multi-system regulatory failure’. Everything was wrong from the US housing & mortgage markets to the global derivatives market, making its impact ubiquitous.

- Federal Reserve policy under Fed chair Alan Greenspan kept the interest rates very low after 9/11. Two things happened as a result, cheap credit was all across the economy fueling US trade deficit as consumers and corporations kept buying from countries like China, and the fed couldn’t deflate the asset bubble in the housing market.
- Because of an unregulated derivatives market, investment banks packaged loans into OTC derivatives like ‘Collateralized Debt Obligations’ (CDOs) and sold them worldwide. These loans-turned-CDOs were contingent on the US housing market, which was in a bubble as cheap credit and low interest rates were prevalent. Therefore, there was a high likelihood for many of them to go bad if the housing bubble had burst. Rating agencies also colluded with these huge investment banks and gave them high ratings. [11]
- Other OTC derivatives like Credit Default Swaps (CDS) were sold to investors for protection against the decline in value of these synthetic CDOs, which were also to go bad if the housing bubble burst. One of the main reasons for the contagion to spread worldwide was that the OTC derivatives market was completely unregulated. [11]
- There were no effective regulations of lending practices, making predatory lending possible. People with poor credit history got loans that they possibly couldn’t repay. Therefore, it went on to be the subprime mortgage crisis as a huge number of subprime foreclosures followed. [11]
- Banking and capital adequacy reforms didn’t keep up with the pace of globalization with an increasing number of ‘too-big-to-fail’ banks at the same time. Basel III reforms were only brought in after the crisis.

III. Basel III Response: DODD-FRANK

The 849-page Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 is a similar attempt to the 37-page Glass Steagall act of 1933 in many aspects. Nevertheless, it was repealed by the Clinton administration. In contrast with Glass Steagall, the Dodd-Frank is a complex piece of reform and regulation for the complex modern economy.

The way Glass Steagall functioned was very simple: It separated commercial and investment banking, thereby making commercial banks low-risk ventures, so that the government could back their deposits under the aegis of Federal Deposit Insurance Corporation (FDIC). Dodd-Frank, beyond probe, is a huge piece of legislation compared to Glass Steagall, involving over 15 titles and several hundreds of sections. The following is a summary of the bill: [12]

- The Dodd-Frank created the Financial Stability Oversight Council (FSOC) to oversee and regulate (if needed) non-bank financial firms like hedge funds and too-big-to fail banks.
- It also created other govt. oversight agencies, such as the Consumer Financial Protection Bureau (CFPB) to protect consumers from ‘unscrupulous business’ practices of big banks, Office of Credit Rating at the SEC to regulate credit ratings agencies and the Federal Insurance Office (FIO) under the Treasury to oversee the insurance industry.
- The Volcker rule which can be compared to Glass Steagall, restrained banks from owning and acting like hedge funds, and compelled them to close their own-profit proprietary trading operations, with certain

exceptions.

- For the first time, Dodd-Frank placed OTC derivatives like credit default swaps under the oversight the SEC or CFTC. A clearinghouse, like a stock exchange for these OTC derivatives, was suggested by the bill to make these instruments more transparent.
- Capital adequacy and liquidity requirements increased for banks and other depository institutions to protect themselves against their risks. Banks like Citi, BofA-ML would be required to have around 9.5% of their assets in liquid capital (cash, govt. bonds etc.) with leverage ratios nearing to 10 to 1 from around 50 to 1 during the crisis.
- Mandatory stress tests under the Federal Reserve like the Comprehensive Capital Analysis and Review (CCAR) that systemically important financial institutions would've to undergo to understand their capital requirements and risk exposures.
- The FDIC has the orderly liquidation authority to streamline individual bankruptcies and prevent the domino effect in the industry.
- Banks were asked to create detailed liquidation and foreclosure plans every year in case of a bankruptcy without inflicting damage on the broader financial system.
- Whistle-blowers were promised financial rewards.
- Above all, Dodd-Frank gave regulators the autonomous power to act according to the status quo. For instance, if a bank failed a CCAR test, regulators could raise its capital requirements and close some of its operations, or cracking down on a too-big-to-fail bank by regulating them or splitting them. It left many of the decisions regarding the oversight of the OTC derivatives market to the regulators. It made the CFPB independent and gave the federal government the power to intervene in special situations.

The full implementation of the bill would take many more years. Criticism regarding many of the rules started ensuing in the years after the enactment of the bill.

Moreover, the republican-led HoR passed the Financial Choice Act (FCA2017) that is yet to pass in the senate. Beyond probe, Dodd-Frank was enacted for the complex modern economy. This is the Glass Steagall of our age. Some of the aforementioned are also the major provisions of the bill that are at the risk of being repealed by the FCA2017. Dodd-Frank is one of an attempt to chain those overweening self-interests that've been wrecking the financial system for decades.

Events leading up to the financial crisis has clearly proven that the free-market is susceptible to human self-interest. Thus, the greater interests of the government in regulating the free-market economy is indispensable.

IV. Financial Innovations & Improvised Regulations

In the wake of several modern financial innovations like crypto-currencies, new types of derivatives and structured financial instruments, there has also been a requisite need for improvised regulation, as many of these innovations do not fall under the domain of many of the existing regulations.

Financial innovations are new financial services, products, intermediaries, markets or delivery channels that often drive the economy towards greater potential by the efficient allocation of resources, higher levels of capital productivity and higher economic growth. Some financial innovations have also been at the flipside of the coin. Thus, financial innovations come with relative merits by contributing to both the GDP and at the same time to the economic fragility of the system – systemic risk.

As financial innovations are of relative merits, it is in the interests of the policymakers to set regulatory laws accordingly. Sometimes, the regulators fail to understand these financial innovations, often due to their complexity.

For instance, bitcoin from a regulatory perspective presents a spree of challenges concerning anonymity, taxation, money laundering, drug trafficking and illicit-activity financing. Nevertheless, the mega challenge is how to regulate it without cutting down on its actual benefits to its end-users. Bitcoin's volatility has clearly proven that it is within a bubble, thus is under the dire need of regulation to reduce the number of market casualties when it bursts.

Another example could be Initial Coin Offerings (ICOs). It's a regulatory hurdle as token buyers are anonymous or pseudonymous and there is an increasing concern that it may be used for money laundering and financing other illicit activities. However, it has also been an effective way for mining and other new firms to raise capital. The Chinese government has cracked down on ICOs by completely banning them, which is not a smart regulatory move.

Similarly, years before the financial crisis, and even to this day, regulators failed to understand the propensity of destruction, which could be brought over by some OTC derivatives, and left those markets unhinged, on the back of intense lobbying by the banking and financial sector.

Thus, there is a clear need for improvised regulatory norms in the wake of these financial innovations. Here are some recommendations regarding the setting of improvised regulatory frameworks for complex financial innovations under the aegis of my research:

- Regulatory norms concerning complex financial innovations like crypto-currencies shall rather be effective in a functional manner, than an institutional manner. A more dynamic approach to regulation with changing regulatory perimeters overtime is required.
- Inquiry commissions with experts from relevant fields shall be employed to help regulators understand the working and the underlying technology of complex financial innovations to aid them in better ways.
- Regulatory norms shall be framed from an unbiased and un-lobbied perspective. The inclusion of lobbying and the regulator's bias could end up making the regulatory laws susceptible to other interests.
- There should be a 'monitoring oversight' on behalf of the regulators concerning market or product developments of these financial innovations, for them to decide on regulatory action, i.e. to act or not to act, in a dynamic regulatory environment.
- Regulators have to often rely on hindsight gained from a better understanding of these innovations and frame laws on a macro-prudential basis.
- Regulators shall be in control of the system, but shall avoid the unnecessary exercise of control.
- Consumer protection shall be ensured. This adds to the stability of the financial system and keeps up market confidence.

V. Concluding Remarks

This paper focused on deregulation in US financial markets because of the prominence of the US economy in the global financial system and the dollar being the predominant global currency. Moreover, the US is also a perfect case study for the horrors of free-market capitalism due to a lack of regulation. Beyond probe, a financial catastrophe in the US would circumnavigate beyond its borders. The inherent risks within the US economy are too appalling to be disregarded.

After a crisis-by-crisis critique, I come to conclude that most major financial crises in the past were caused for these reasons:

- Inappropriate interest rate environments.
- Bleated banking reforms.
- Less-stringent regulations.
- Unnecessary, untimely and unsound deregulation.
- Unregulated OTC markets and less-regulated mainstream financial markets.
- Detrimental financial products.
- A failure of the ecosystem supporting financial markets – Governments, regulators and credit rating agencies failing to play their roles.

Post-crisis regulatory efforts like the Glass Steagall and Dodd-Frank are long-term measures to ensure the health of an economy and the financial system underlying it, which have also been under the threat of replacement with less-stringent regulations.

With regard to all of this, it would be apposite to say that, the 'American Laissez-Faire Financial Regulatory Regime' has been an absolute fiasco. The system of free-market capitalism is at the greatest threat of being obliterated when there is a lack of regulation and a locale of lawlessness in the economy. In the absence of a proper regulatory system, a reality that the US is re-exploring, we mayn't be far from the next major financial crisis.

In the wake of several modern financial innovations, the need for improvised regulations has been pertinent. Regulations for complex financial innovations have to be formulated unbiased, based on the working and underlying technology of these innovations in a more dynamic regulatory environment on a macro-prudential basis, with requisite oversight of market and product developments and by ensuring consumer protection.

To conclude, former Fed chair Alan Greenspan, once champion of the laissez-faire regulatory regime was quoted during a congressional hearing after the financial crisis, "Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief." [13]

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